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JAPAN'S SHORT-TERM FINANCIAL MARKET

Summary

Japan's short-term financial market has undergone major changes since the structure of the economy and flow of funds forced the formerly limited interbank market to expand and liberalize. The emergence of the "gensaki" market, where bonds are traded under resale or repurchase agreements free of the intervention of monetary authorities, gave large corporations the opportunity to invest at market rates and supplied borrowers with additional sources of funds. The liberalized short-term financial market has led to active interest-rate arbitrage that suggests the possible emergence of a domestic market pattern similar to the U.S. system. The new Foreign Exchange and Foreign Trade Control Law has also tended to activate interest-rate arbitrage between Japanese and overseas markets.

Overview

Japan's short-term financial markets consist of the call money and bill discount markets, the gensaki market and the market for certificates of deposit. In recent years the importance of these markets has been growing rapidly. The ratio of funds in these accounts to the gross national product increased from 2.5 percent in 1965 to 5.8 percent in 1975 and 7.1 percent in 1980. The call money and discount markets are interbank transactions to supply financial institutions with temporary funding at interest rates that fluctuate according to the discount rate set by the Bank of Japan as well as by its general monetary policy stance. The call and discount markets are conducted exclusively between private financial institutions; private corporations and individuals are not permitted to participate directly in these markets.

The development of the open market (gensaki and certificates of deposit), in which nonbanking corporations can invest and borrow, has been rapid. Two factors account for

this interest: the gensaki market has provided a superior alternative to short-term bank deposits; and the rising government debt necessitated growing markets. The open markets have increased their share of the total outstanding in the short-term markets from 21.4 percent in 1975 to 41.0 percent in 1980, while interbank markets (call and discount) have lost their 78.6-percent share (1975), dropping to 59.0 percent in 1980 (Table 1).

Interbank Market

The interbank market enables financial institutions to borrow on a short-term basis to meet their reserve requirements. Participants are limited to those who deal with the central bank. Thus far, the system is similar to the federal funds market in the United States. But in Japan, the city banks (the 13 largest banks in Japan) have also been borrowers in the short-term markets, providing capital for industry in the high economic growth period. The Bank of Japan made direct loans to the city banks through the two interbank money markets — the call and bill discount markets. However, as the economy slowed, the interbank market declined in importance. Each of these two types of transactions is reviewed here.

Call Market — Call transactions are those negotiated by financial institutions. Private corporations and individuals are not permitted in this market. Through money dealers (tanshi gaisha), who act as brokers, surplus savings held by financial institutions are funneled to the cash-short city banks. Funds in the call market are composed of three different maturities — half-day money, unconditional money and fixed maturity money. Half-day money does not require collateral because it is cleared within the day. Unconditional money is repayable on the next business day. Fixed maturity money is repayable in two to seven days. Unconditional and fixed maturity instruments require high-quality collateral, including government bonds, bank debentures, corporate bonds and debentures, first-class bills endorsed by banks, Treasury bills, etc.

As of the end of 1982, outstanding call loans totaled ¥4.5 trillion (about $19.5 billion). The largest suppliers of funds were the trust banks (27.1 percent), followed by the National Federation of Credit Associations and individual credit associations (12.0 percent), financial institutions for agriculture and forestry (11.1 percent) and regional banks (9.8 percent). The city banks were the largest borrowers (71.9 percent).

Bill Discount Market — The bill discount market was instituted in May 1971 and is analogous to bankers acceptances, offering funds for longer terms than available in the call markets. Like the call market, only financial institutions can participate in the bill discount market. The bills come in one-, two-, three-, or four-month maturities. Investors can resell the bills without restriction 30 days after they have been issued. All transactions are carried out through tanshi houses by telephone.

Because the volume outstanding in the bill discount market fluctuates, the market has been used by the Bank of Japan to adjust the impact of interest-rate fluctuations and capital movements. As the liberalization of short-term markets has proceeded, the trading volume has increased. As of the end of 1982, outstanding balances were ¥5.4 trillion (about $23.5 billion). The largest lenders were financial institutions for agriculture and forestry (29.3 percent) and credit associations (23.9 percent). The credit created was loaned primarily to the city banks (79.2 percent).

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Unrestricted Markets

The corporate sector, as noted earlier, was not allowed to participate in the interbank markets. In addition, the Bank of Japan excluded bank debentures from its portfolio in its monetary operations so the banks had to rely on the corporate sector for the placement of new bank debentures. The combined effect of these developments encouraged the corporate sector to participate in the gensaki market. As this market expanded, the corporate sector sought further alternatives and in May 1979, private financial institutions were permitted to issue negotiable certificates of deposit. Still another step toward liberalization was the introduction of Treasury bills for sale to the public in 1981 and 1982.

Gensaki (Repurchase Agreements) — In a gensaki transaction, the sale and repurchase of bonds is mediated by a securities company. The borrowing and lending is for a specific period of time under a repurchase agreement. The difference between the purchase and resale prices represents interest income to the investor. The gensaki market has been allowed to develop relatively free of government intervention. The rates paid in this market are not regulated and fluctuate according to the supply and demand for short-term money.

Gensaki agreements expanded rapidly in the early 1970s when corporations and other institutions had excess liquidity and wanted to maximize their return on short-term investments. Participation in this market by non-residents was permitted in 1979 and a year later it was opened to city banks. Since 1980, when the Foreign Exchange and Foreign Trade Control Law was amended, the volume traded by non-residents has gradually increased and now accounts for 11.0 percent of the total outstanding balance of bond purchases. At its peak, volume in this market reached about $19.6 billion. With the rapid increase in certificates of deposit, however, an instrument which is not subject to the security transaction tax, and competition from the sale of Treasury bills, it has dropped somewhat to $18.7 billion.

Certificates of Deposit — The CD market has grown rapidly since its introduction in May 1979 and holdings have reached a size roughly equivalent to the other short-term financial instruments, making it an important money market category for banks. However, because of various restrictions, only a narrow range of participants can invest in CDs since the minimum purchase is ¥500 million (about $2.2 million) and the terms are three to six months. In 1982, issues totaled about $18.8 billion.

City banks, trust and long-term credit banks, mutual savings and loans, foreign banks and credit associations are allowed to issue CDs; the major buyers are large cash-heavy corporations. The certificates are subject to a 35-percent withholding tax for residents (10 percent for non-residents) at maturity. Investors who resell CDs before maturity pay no tax. Secondary trading of CDs is not subject to the security transaction tax imposed in the gensaki market.

Market trading of CDs has been very popular since 1980 when the tanshi houses began to offer them. At the time, dealings in the call and bill discount markets were stagnant. The experience of selling Treasury bills on behalf of the Bank of Japan gave the tanshi houses credibility with the corporate sector, enabling them to promote the new market. Except for alteration of the ceiling amount, the terms and restrictions originally imposed on CDs remain unchanged. As a result, participants are pressing for reforms to make the certificates more competitive. Specifically, a reduction in the minimum size of the transaction would attract more buyers, as would more flexible maturities.

Rapid Expansion of the Market

A number of different developments have stimulated the gradual freeing of the domestic short-term market. First, as the Japanese economy slipped into slower growth in the 1970s after the oil crisis, the corporate sector found itself with a surplus of cash. Simultaneously, the public sector's needs expanded as a result of decisions to stimulate spending by issuing government bonds. Corporate investors, in an effort to manage their financial portfolios more effectively, became very sensitive to interest rates. Individuals also showed a growing desire to diversify holdings into higher interest-rate instruments as income growth slowed. And private financial institutions, reflecting an awareness that their share of the financial market depended on a response to the preferences of the private sector, began to call for decontrol.

At the same time, the size and importance of international monetary transactions increased. Foreign pressures to liberalize and internationalize Japan's financial markets mounted, as Japanese financial institutions moved into overseas investments and steps were taken to encourage the flow of foreign currency into Japan. With the introduction of some steps to liberalize the gensaki market and allow non-residents to make yen deposits, the direction of movement was clear, and in 1980, the new foreign exchange control law came into effect. During the recession, with financial demand stagnant, corporations and financial institutions were wary of long-term issues and were persuaded by international monetary problems to pursue low-risk short-term investments. An accompanying factor was that the excess liquidity in the corporate sector and massive issues of government bonds left the authorities without adequate ways to directly control lending activities. It became important to influence portfolio selection by affecting interest rates. With the increase in the flow of funds, interest rates had to be allowed to allocate resources throughout the economy.

Liberalization in the Short-Term Market

Before liberalization, the call and bill discount rates did not precisely reflect the true demand-supply situation. The quotation system which fixed the call rate was decided by a consensus of major borrowers and lenders. The quotations were changed only once or twice a month, based on reasons which both parties considered appropriate — for example, the pattern of seasonal adjustments. Therefore, when the market changed or expectations for future rates shifted rapidly, the quotations did not accurately follow the developing market situation. When liberalization began in 1978, the changes were gradual. In the call market, quotations were changed more frequently; seven-day call money was introduced in 1978 and the quotation system for call money was entirely abolished in 1979.

In the bill discount market, the resale of bills before maturity without restriction began in 1978. The free-rate one-month bill was introduced and the rates were liberalized for those bills with a maturity of over three months. The quotation system was abolished in October 1979. The interest rates prevailing in the market today respond to the supply and demand situation, market expectations and the monetary policy imposed by the Bank of Japan in pursuit of a desired level of interest rates. The introduction of greater flexibility in the interbank market also increased interest-rate arbitrage between the domestic and international markets.

In the gensaki markets, though, the restrictions imposed on bonds with repurchase agreements impeded smooth interest-rate arbitrage. From 1978, many of these restrictions were relaxed and the limitations on the volume of bond sales with repurchase agreements by city banks was abolished, improving intermarket arbitrage. The system

moved further in this direction when in 1981, the Bank of Japan sold Treasury bills to the non-banking private sector and the new foreign exchange law encouraged arbitrage between Japanese and overseas markets. The marked growth in interest arbitrage transactions was joined by foreign banks in Japan, securities companies and corporations anxious to find the most effective placement at home and abroad, as well as by the diversification of methods of trading with overseas markets such as non-resident yen deposits, short-term loans, resident foreign currency deposits and purchases of overseas bonds.

Future Development

The Bank of Japan began to sell Treasury bills from its holdings in 1981 in order to absorb surplus funds from the short-term market. The lack of a well-developed market for these bills has been a severe deficiency. Many economists consider it important to broaden the available instruments since the central bank presently is limited in its ability to adjust the supply and demand for short-term funds in the market. Lacking a Treasury bill market in the past, Japan has had no equivalent to the Federal Reserve System's open market operations as a tool of monetary policy. Further, all public bonds issued since 1974 will shortly mature and will compete with the Treasury bills -- making deregulation of the uncompetitive, low interest rates on Treasury bills imperative.

Tokyo's dollar call market started in 1972 to lend or borrow foreign currency-denominated short-term funds in Japan. The practices are based on trading in the Eurodollar market and have been enhanced by the new foreign exchange law and the liberalization of short-term foreign loans. Participants in the Tokyo dollar call market are foreign-exchange banks approved by the MOF and the size of the market is necessarily limited. Consequently, pressure is building to establish an off-shore market in Tokyo. However, it is unclear yet just when or in what form this development will materialize.

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For further information, contact Yoshio Nakamura.

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Table 1: Outstanding Balance of Short-Term Financial Assets

(in billions of yen, end of year figures)

	Call Money		Bills Discounted		Gensaki (repurchase agreements)		Certificates of Deposit		Total	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
1975	¥2,332	27.2%	¥4,403	51.4%	¥1,836	21.4%			¥8,570	100%
1976	2,567	26.3	5,091	52.3	2,084	21.4			9,742	100
1977	2,614	22.7	6,084	51.4	3,136	26.5			11,837	100
1978	2,326	17.7	6,590	50.2	4,207	32.1			13,123	100
1979	3,472	22.3	6,327	40.6	3,960	25.4	¥1,820	11.7%	15,580	100
1980	4,133	24.7	5,738	34.3	4,507	26.9	2,358	14.1	16,736	100
1981	4,699	28.5	4,015	24.3	4,481	27.2	3,291	20.0	16,486	100
1982	4,473	24.2	5,413	29.2	4,303	23.2	4,342	23.4	18,552	100

Source: Bank of Japan